Executive Compensation Is a Powerful Communication to Stakeholders

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Although the primary purpose of executive compensation is to attract and retain top leaders, compensation plans also send messages to external and internal stakeholders such as investors, other executives and employees.

In recent years, there has been increased effort by companies and their boards to use the various elements of compensation to communicate how they are addressing the wide-ranging and often-contradictory interests of multiple stakeholders. This evolution has created both challenges and opportunities for human resources leaders to collaborate with the board and senior leadership to advance executive compensation as a source of strategic impact with a focus on reasonableness of total pay, incentive metrics and pay equity.

Corporate Purpose and Corporate Ownership

The shift from shareholder to stakeholder capitalism is often traced to a 1970 *New York Times Magazine* article by Milton Friedman, "The Social Responsibility of Business Is to Increase its Profits," which famously stated that the corporate executive is "an employee of the owners of the business" and has a duty to "conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to their basic rules of the society, both those embodied in law and those embodied in ethical custom."[1]

Since then, there has been a dramatic shift from individual shareholders owning publicly traded shares to institutional investors holding the majority of the equity. In 1950, individuals owned roughly 90 percent of the common stock of U.S. corporations. Today, common stock owned by retail investors has declined to less than 30 percent.[2]

While executive compensation programs have historically been designed to drive performance on key financial objectives and stock performance, many companies realize that pay for financial performance is only one of the factors that stakeholders consider when assessing the appropriateness of executive pay.

This dramatic shift has changed the composition of "owners" and their corresponding "desires" that executives must serve. Friedman's narrowly prescribed profit-focused objectives are out of sync with recent conversations about the purpose of the corporation. Institutional investors increasingly are seeking to promote their interests regarding the broader social responsibility of corporations and the corresponding role that executive compensation plays in advancing such goals.

This evolution in investor expectations is reflected in the 2019 release of the Statement on the Purpose of a Corporation by the Business Roundtable (BRT), the trade association representing leading American corporations whose members have combined revenues of over $7 trillion. The BRT statement emphasizes that corporations have multiple stakeholders and should focus on serving the interests of "customers, employees, suppliers and shareholders."[3]

Somewhat ironic in light of Friedman's admonishment that the executives not stray from their duty to focus on profits and serving shareholders, the BRT Statement places shareholders last on the list of stakeholders that corporations should serve. However, the BRT ranking of stakeholders deserving the commitment of corporations is not shared by all investors. The Council of Institutional Investors (CII), whose members manage assets of roughly $4 trillion, voiced disagreement with the BRT's prioritization of shareholder interests below that of other stakeholders, stating,

> *"We respectfully disagree with the statement issued by the BRT … The BRT statement suggests corporate obligations to a variety of stakeholders, placing shareholders last, and referencing shareholders simply as providers of capital rather than as owners. CII believes boards and managers need to sustain a focus on long-term shareholder value. To achieve long-term shareholder value, it is critical to respect stakeholders, but also to have clear accountability to company owners."*[4]

The growth in impact investment, sometimes referred to as social investment funds, has added to the various views that investors express regarding the role and purpose of the corporation. "Impact investing has become one of the hottest strategies in fund management … At its core, impact investing is an emerging field of asset management where environmental or social outcomes are valued as highly as financial returns."[5] Investment funds focused on environmental and social issues manage assets of more than half a trillion dollars.[6]

The focus on broader social issues is shared by the largest institutional investors, including BlackRock and State Street, which together manage $10 trillion in assets. The 2020 annual letter from BlackRock to the CEOs of companies in which BlackRock invests encourages a focus on sustainability and climate control, and that their impact be incorporated in "disclosures and business practices and plans,"[7] signaling BlackRock's expectation that incentive objectives should also incorporate metrics supportive of performance in the areas of social responsibility.

Similarly, State Street President and CEO Ron O'Hanley stated, "As stewards of our clients' assets, we are deeply invested in understanding the environmental, social and governance (ESG) issues that are material to a company's ability to generate sustainable performance."[8] Investor focus on ESG resulted in ExxonMobil shareholders voting to replace two board members with director candidates committed to increasing Exxon's focus on "cleaner energy and away from oil and gas."[9]

Given these evolving expectations, many boards are taking steps to structure and disclose executive compensation arrangements. The need to balance the varying interests of investors has become increasingly important following the introduction in 2011 of the ability of shareholders to vote on executive pay, termed "say on pay," introduced in the Dodd-Frank Act following the financial crisis of 2009.[10] With the introduction of say on pay, and the corresponding increase in company and board of director engagement with top investors, companies have paid greater attention to viewing executive compensation as an important form of communication.

An Expanded View of Pay for Performance

While executive compensation programs have historically been designed to drive performance on key financial objectives and stock performance, many companies realize that pay for financial performance is only one of the factors that stakeholders consider when assessing the appropriateness of executive pay.

Investors now expect a well-designed executive pay program to address:

- **Reasonableness of total pay.** How does the absolute level of pay for executives compare to similar-size companies and those in the same industry? Is the majority of pay contingent upon achieving performance objectives and is the balance of pay focused on long-term performance and alignment with shareholders? Is the level of incentive compensation reasonable in relation to the performance of the company? The 2021 proxy season has witnessed an increase in the number of companies in which a majority of shareholders have voted against executive compensation packages. "Among the companies who've experienced shareholder rejection of 2020 pay, representing their first failed say-on-pay vote since inception, are Starbucks, Walgreens, AT&T and Marathon Petroleum Corporation."[11]
- **Incentive metrics.** Do metrics motivate accomplishment of outcomes beyond financial performance? Are executives incentivized to accomplish objectives that advance sustainability, employee engagement, worker health and safety, diversity and other areas of corporate social responsibility?
- **Pay equity.** Is there a reasonable relationship between the compensation of senior executives and pay for the average worker? Does the company take steps to reduce any gap that exists between the pay of women and men?

Companies failing to communicate a clear linkage between executive pay and the interests of shareholders may face increased pressure from investors in the form of low support in the annual say on pay vote, submission of shareholder proposals seeking changes to the design and disclosure of executive pay, and votes against the reelection of board members, particularly members of the compensation committee. Activist investors seeking to gain influence to promote a specific agenda may use shareholder dissatisfaction with the board's management of executive pay as a wedge in an attempt to gain board seats or other concessions.

In response to investor and other stakeholder interests, companies are revising their compensation programs and disclosures to better communicate alignment with the variety of stakeholder expectations. Consistent with the investor expectations outlined above, key messages that companies are communicating through the design of executive compensation include:

- **Reasonableness of total pay.** Companies are providing additional details in their proxy disclosures describing how executive pay decisions are made. The market comparisons used in setting pay, referred to as "peer companies," are spelled out in significant detail as is the targeted competitive position for executive pay.[12] It is highly unusual for companies, after the 2011 introduction of say on pay, to establish competitive pay objectives above the median of prevailing market rates. In addition to providing greater clarity on how companies set targeted levels of executive pay, the disclosure of the reasonableness of pay in relation to performance has taken on greater importance, prompting many companies to describe how current performance compares to historical trends, the business context within which results were achieved, and the overall rigor of performance metrics.
- **Incentive metrics.** Best practices in the disclosure of executive compensation include detailed discussion of the metrics for short-term and long-term incentives. Historically, incentive metrics were primarily focused on measuring financial performance, such as revenue and profit growth, and the quality of performance, as reflected in cash flow and return objectives. Increasingly, incentive objectives reflect the interests of various stakeholders and the priorities of investors beyond financial performance. Environmental and social objectives—such as greenhouse gas emissions, water conservation, employee engagement and diversity—are increasing in prevalence in executive incentive plans. A survey by the executive compensation consulting firm Willis Towers Watson found that "Just over half (51 percent) of S&P 500 companies use environmental, social and governance (ESG) metrics as part of their compensation evaluations."[13] Notable examples of companies incorporating ESG metrics in executive compensation include PepsiCo (reduced use of plastics[14]), Shell (safety and environment[15]) and Intel (corporate responsibility, including diversity and inclusion, environmental sustainability[16]).
- **Pay equity.** Beginning in 2018 companies were required under the Dodd-Frank Act to disclose the ratio of CEO pay to the

pay of the "median worker."[17] While the pay ratio disclosure provides general information about how CEO pay compares to the pay of the median employee, it provided little insight into how equitably a company manages pay. Investors, most notably Arjuna Capital, have pressured companies to provide greater disclosure on the pay of men and women in an attempt to more clearly assess gender pay equity. Many companies have disclosed information regarding gender pay equity, some due to pressure from investors and others voluntarily, to demonstrate their progress in addressing pay equity. Starbucks voluntarily disclosed 100 percent pay equity for men, women and people of all races in its US workforce.[18] Citigroup reported that median pay for women in its global workforce was 71 percent of the median for men. However, when adjusted for factors such as job function, level and geography, women earned 99 percent of their male counterparts' compensation and the company is working to reduce the pay gap.[19]

In response to investor pressure, including shareholder proposals submitted by Scott Stringer, the New York City Comptroller, and the New York City retirement funds to 67 S&P 100 companies, a substantial majority of the S&P 100 companies have committed to disclose their EEO-1 data.[20] At their 2021 annual shareholder meetings, 84 percent of DuPont shareholders and 86 percent of Union Pacific shareholders supported the proposal submitted by the New York City Comptroller requesting company disclosure of their EEO-1 reports.[21] In response to the shareholder votes, Stringer stated that, "Companies are strongest when they reflect the full diversity of our workforce. Shareholders overwhelmingly voted for disclosure that will provide them with critical information to hold these companies accountable."

Executive Pay as Communication to Internal Stakeholders

While executive pay is a powerful communication to investors and other external stakeholders, it sends an equally powerful message to the company's employees. For participants in the executive pay programs, performance metrics signal where they should focus their efforts, consistent with the performance areas that senior management and the board have identified as supportive of value creation and the strategy of the company. The form of pay also serves a form of communication, in terms of the timeframe over which performance will be measured (annual vs. long-term), the alignment with shareholders (equity compensation), the management of risk (caps on incentive payouts and the mix of awards) and the company's assessment of the value of the specific executive's contribution and career potential (variance in the pay of individual executives). Each element of pay—salary, annual incentive, long-term incentives and perquisites—reinforces a different message regarding the expectations of performance and potential.

For employees below the executive ranks, executive compensation also serves as an important form of communication. For example, if a company is encountering a decline in sales or profitability and imposes cost-saving measures impacting the workforce (such as reduced merit increases, laying off or terminating employees) while at the same time disclosing increased compensation for executives, the conflicting messages communicated by these actions would be counter to a culture of collaboration and fairness that most corporations outline in their mission statements and values.

The COVID-19 pandemic provides examples of companies consciously taking actions that impact the pay of senior executives to communicate a culture of shared sacrifice and alignment of the interests of executives and other employees. In the face of workforce reductions and reduced earnings resulting from the disruption caused by the pandemic, many companies reduced the pay of senior executives to communicate a culture of shared sacrifice. A substantial number of CEOs and boards of directors voluntarily took temporary pay reductions in response to the impact of the COVID-19 crisis and the corresponding displacement of company employees.[22]

Moving Forward

Although the primary purpose of executive compensation design is to support the company's need to attract, retain and motivate the requisite caliber of leadership to achieve the business strategy and drive sustained performance, other considerations influence pay decisions. Thoughtfully designed and communicated executive compensation programs help motivate the accomplishment of operational and strategic objectives, create sustained increase in shareholder value, focus attention on the achievement of goals in the areas of corporate social responsibility, and reinforce the desired corporate culture.

Compensation committees, with support from HR leadership and external consultants, need to carefully consider reasonableness of total pay, incentive metrics and pay equity from a multi-stakeholder point of view when structuring and communicating executive compensation plans. The historically narrow view of executive compensation as a transaction between the company and the executive driven solely by financial metrics has given way to the realization that various stakeholders, both external and internal, have an interest in executive pay decisions. This evolution is a positive step for business, society and the world.

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